Capitalizing on opportunities
Private equity investment in oil and gas
Methodology

In Q1 2016, Mergermarket surveyed 100 managing directors and partners from private equity firms that have made at least one investment in the oil and gas sector over the past two years. More than half of respondents (52%) are based in North America, 26% in Europe, 12% in the Asia-Pacific region, 5% in Latin America and 5% in the Middle East and Africa.
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State of play

As companies struggle with the drop in oil prices, private equity firms are looking at the oil and gas sector with renewed interest as the industry continues to transform.

Global PE deals in the oil and gas sector, 2007–16

- Number of announced deals
- Deal value US$m

Source: Mergermarket
The dramatic fall in oil prices that began in late 2014 abruptly ended several years of almost uninterrupted prosperity for the oil and gas industry and significantly slowed M&A activity.

The price slump has been at the heart of a drop in announced deal volume – down 40% from 2014 to 448 deals in 2015. Whilst deal value remained stable with a 1% decline over the same period to US$403.9b, this is largely down to a few outlier megadeals.

Companies are struggling with the financial reality of excess debt and squeezed profits that the lower price of oil and gas entails, leading to a rapid transformation of the sector. However, this environment is also providing opportunities for astute investors, and private equity (PE) firms are striving to uncover the silver lining of a depressed commodity price environment.

Much of global PE firms’ dry powder is yet to be deployed, having grown to US$971.4b in June 2016, according to research firm Preqin. With a restrained financing environment for oil and gas companies, from traditional sources particularly in the mid-size range, PE funds are looking to make inroads into the sector. But what opportunities are available and when and how should PE tackle an increasingly complex and stressed industry?

Given the challenges and opportunities in the current economic environment, EY, in association with Mergermarket, looked to uncover PE firms’ appetite for investment into the oil and gas sector.

**Key findings**

Our survey reveals PE funds are aiming to raise more money to invest in the industry. However, we also found a PE community still wary of current market volatility and seemingly hesitant to invest, waiting to see if the downturn has definitely hit bottom – an understandable stance, with respondents more inclined to start investing in early 2017.

The valuation gap between buyers and sellers – the “bid-ask spread” – has also persisted into 2016. This is a result of buyers expecting bargains at a time when sellers are loath to part with quality assets at low prices, or, alternatively, buyers and sellers having very different views about the future of commodity prices. This, in turn, may give rise to more innovative deal structures, as firms test the waters with joint ventures, strategic partnerships, or become more creative with hybrid equity type investments. We see PE firms potentially having to over-equitize as banks’ lending appetite may be more restricted.

Amid cost-cutting and the servicing of massive debt accumulated during the boom years, the oil and gas industry’s need for operational and growth capital is as large as ever. And PE is well-positioned to fill the gap.

**PE deal trends**

After a productive 2014 for PE deals in the oil and gas sector – 104 deals worth US$38.6b, according to Mergermarket data – activity slowed significantly in Q1 2015, in step with the drop in the price of oil. However, after a tepid start, 2015 picked up and was very much in line with previous years, down only 7% in deal volume and 10% value compared with 2013. The first quarter of 2016 has also seen material PE activity with 12 deals worth US$7.6b, including notable midstream deals, such as a group of US-based PE investors acquiring a 12.3% stake in Plains All American Pipeline for US$1.5b. Despite the downturn in the price of oil, recent deal activity indicates that PE firms still believe the sector offers a solid value proposition – though perhaps in different parts of the value chain.
Strategic perspectives

Favorable asset valuations and the scarcity of more traditional financing sources are set to drive PE activity in the oil and gas sector.

Providing growth capital is the most important way that PE can add value to corporates, according to 63% of respondents.

53% see improving the operational performance of portfolio companies as their top priority in the next 12 to 24 months.
The sector’s need for growth capital will drive activity in the coming year. In the past decade, PE has made great inroads into the oil and gas sector, as cheap credit from the US Federal Reserve financed the resources boom in North America. In 2014, North American PE firms accounted for 67% in volume and 83% in value of all global PE oil and gas sector deals, far outstripping all previous years.

While the downturn in the industry has undoubtedly challenged the firms looking to protect their investments and grow their portfolio companies, those that are willing to commit fresh capital (and potentially hold onto the investments for a longer period of time) could benefit from the current low-for-longer price environment.

Our survey finds that the main driver for PE activity is the emergence of favorable valuations for industry assets. Almost two-thirds (64%) say that declining company valuations will provide good buyout opportunities. From this, we conclude that PE firms believe that valuations will favor the buyer. This will ensure firms get the right assets – ones that are properly priced and valued.

“The valuations are very low now, which is certainly attractive to PE firms,” says the managing partner at a Canadian PE firm. “Senior people in companies throughout the sector are more willing to listen and share their growth plans with PE as other (more traditional) routes to capital investment are being shut down.”

What are the top two drivers of PE activity in the oil and gas sector?

- Favorable asset valuations via pressure from low oil prices: 64%
- Scarcity of traditional financing sources or corporates: 44%
- Access to technological innovation: 28%
- Distress/bankruptcies: 23%
- Access to management teams: 16%
- Fallout from megadeals and sector consolidation: 14%
- Market dislocation opportunities: 11%

What is the main way PE can add value to an oil and gas company?

- Growth capital: 63%
- Providing operational expertise: 16%
- Providing access to networks: 11%
- Geographic expansion: 6%
- Placing effective leadership/executives: 4%
The route to financing

Increased collaboration and openness of companies throughout the sector has likely evolved due to the scarcity of traditional sources of financing, according to 44% of respondents.

When the price of oil was high, easily accessible financing supplied ever more capital-intensive projects offshore around the world, especially megaprojects. However, when prices tumbled, companies found themselves not only increasingly unable to service debt, but also facing difficulties in tapping traditional sources of financing. Operators took aggressive action to increase liquidity by cutting capex, amending credit facilities and squeezing suppliers. But by the last quarter of 2015, the sustained levels of low commodity pricing began to erode liquidity. In order to arrange attractive funding or growth capital will be faced with challenges on how to survive, let alone thrive.

As cost-cutting and efficiency moved to the forefront amid the downturn, 16% of buyout firms feel they can add most value with their operational expertise. With margin and pricing pressure at significant levels, being efficient with resources and operationalizing projects in a lean and effective manner is of the utmost importance. Firms that can offer operational expertise may well discover significant synergies that could be well-received in the current price environment.

“PE firms have a good deal of sector knowledge,” says a partner at a US PE firm. “Therefore, the expectation is they can help in providing operational expertise, especially those firms which invest in growth capital and in oil infrastructure.”

Value added by PE

Our survey shows that the majority of respondents (63%) believe providing growth capital is one of the most important ways PE can add value to corporates. Growth capital from PE can free up much-needed working capital and provide stability, while also supplying acquisition funding or financing to enter new markets during a time when profit margins have shrunk significantly.

Companies able to either self-fund or arrange much-needed financing will be able to continue to build reserves, make acquisitions, or develop new projects, which could be a further differentiating factor. Companies unable to secure financing for working capital or growth capital will be faced with challenges on how to survive, let alone thrive.

EY bankruptcy overview

In 2016, stress from reduced cash flow and more limited access to financing has triggered an increase in bankruptcy cases among oil and gas sector corporates.

Global bankruptcies among exploration and production (E&P) companies in 2015 amounted to just over 40, while in the first five months of 2016 close to 30 companies have already declared bankruptcy, according to EY’s Bankruptcy Index. Liabilities for E&P companies that have filed for bankruptcy have also increased from approximately US$16b in 2015 to US$35b in 2016.

Liabilities for midstream companies have been slower to emerge as this segment is largely shielded by long-term agreements and lower capital cost, but liabilities have already surpassed US$1b so far in 2016.

Pressure is also coming to a head for oilfield services providers, which saw a considerable amount of bankruptcies in 2015, with almost 40 cases globally. However, this segment is more flexible in terms of operational efficiencies and capital expenditures and is better positioned to weather the downturn. In 2016, so far, just over 10 companies have filed for bankruptcy. Debt obligations in this segment are also stacking up with approximately US$2.5b through May 2016 – compared to US$5b in 2015.
Future funding
When asked about the top priorities for their fund in the next 12-24 months, over half (53%) of respondents state improving operational performance of portfolio companies is paramount. While the current market situation might not be an ideal exit environment, streamlining existing portfolio companies can achieve a better sale value when the market becomes attractive again.

“The current market conditions are not favorable for an exit, so we are trying to enhance the efficiency and profitability of assets for when the market takes an upturn,” says the managing director at a US PE firm.

In situations where portfolio companies’ performance is falling short of expectations, PE firms may find increasing their stake, or taking smaller companies private, can give them greater control over operational decision-making.

“We need to improve the way our portfolio companies are running; there is a need for efficient methods and better management,” says the managing director at a US PE firm.

“We are investing in our own portfolio of companies as prices are low and we are able to get them for a good deal. It gives us more control over the company.”

In addition to contract renegotiations with suppliers and contractors, innovation in automation technology and digital processes can also bring about a turnaround for existing operations and create new efficiencies. Often, M&A activity can accelerate the innovation process. Indeed, 37% of respondents indicate they are looking to make acquisitions, aiming to take advantage of potentially lower valuations and distressed asset sales, whereby the merged company will offer efficiencies and higher returns. However, it is absolutely vital firms target the right acquisition to benefit the existing portfolio company. This can be challenging, according to some respondents.

“Finding the right target needs a methodical framework for identifying and measuring firm-specific operational factors that will contribute to the portfolio company’s shortcomings,” says the senior managing director at a US PE firm. “The approach we take evaluates all the facets of a firm’s investment operation. We go beyond the prevailing notion fostered by transaction cost analysis that trading and the effect of commissions and market impact is the dominant driver of suboptimal portfolio performance.”
Tactical terrains

Asia-Pacific and North America are set to dominate PE plans in the coming years, with Africa also on the rise.

All respondents feel that PE activity in the Asia-Pacific region will increase in the next 12 to 24 months.

99% feel the same about North America.

98% expect growth equity to be the most popular PE deal type in Asia-Pacific.

88% feel the same about North America.
Our survey reveals that private capital is increasingly responding to the rising energy demand of emerging economies.

**Asia-Pacific attractions**
All respondents expect to see more PE involvement in Asia-Pacific, which has a large and growing energy market. By comparison, our 2013 report *Financing the future energy landscape* showed that just 79% expected PE interest in oil and gas to rise in the region, while 21% expected it to either remain the same or decrease. In addition, while the survey shows that only 13% are currently active in the region, 41% are looking to invest in the region in the next 12 to 24 months.

Asia-Pacific draws investors due to its low cost and ease of doing business, as well as general macroeconomic growth. The region also boasts new, albeit capital-intensive, exploration and production potential in emerging areas, such as Vietnam’s Mekong Delta and the Andaman Sea off the coast of Myanmar.

**African growth**
Despite the fact that only 1% of respondents are currently active in Africa, there is an anticipation that dealmaking will grow in the region, with 80% believing activity will increase, compared with 68% in 2013. Investors are being drawn by the promise of new infrastructure initiatives across the continent, opening up new trade routes and enhancing regional integration, such as rail and port developments in Mozambique and Angola, as well as stronger regulatory systems and increasing transparency in many countries, such as Kenya and Ethiopia. “Strong growth, rising demand and limited competition for deals are driving increased interest in Africa,” says the managing director at a US PE firm. “The continent has long held enormous promise but was overshadowed by a legacy of conflict, corruption and economic crises. However, the region has seen a broad range of reforms recently. We look forward to investing in Africa over the coming years.”

**What do you expect to happen to the level of PE interest in each of the following regions?**

<table>
<thead>
<tr>
<th>Region</th>
<th>Increase</th>
<th>Remain the same</th>
<th>Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia-Pacific</td>
<td>100%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>North America</td>
<td>99%</td>
<td>1%</td>
<td>0%</td>
</tr>
<tr>
<td>Africa</td>
<td>80%</td>
<td>13%</td>
<td>7%</td>
</tr>
<tr>
<td>Europe</td>
<td>69%</td>
<td>9%</td>
<td>22%</td>
</tr>
<tr>
<td>Latin America</td>
<td>65%</td>
<td>9%</td>
<td>25%</td>
</tr>
<tr>
<td>Middle East</td>
<td>31%</td>
<td>39%</td>
<td>30%</td>
</tr>
</tbody>
</table>
Latin America – smaller nations rise
Meanwhile, Latin America is looking for growth capital and infrastructure investments, especially midstream segments, and has plenty of discovery potential for upstream companies. Interestingly, despite the current economic downturn in the region, not a single respondent sees PE interest decreasing with 65% expecting an increase. Yet respondents are more reserved than they were in 2013, when 82% expected PE interest in Latin America to rise. In addition, those looking to invest in Latin America is a mere 26% of respondents.

While Mexico and Brazil are the dominant Latin American markets due to the size of their economies, the two regional powerhouses have found themselves falling behind their smaller neighbors in recent years. Mexican energy reform has been slow to attract new stakeholders, and Brazil's national oil company has been involved in corruption scandals. Countries, such as Colombia and Peru, are becoming more interesting to those with emerging market risk appetite. These countries also present less political risk than their Latin American neighbors.

Middle East slowdown
Only 31% of respondents believe PE's interest in the Middle East will increase, compared with 64% three years ago. This is not surprising given the geopolitical dynamics in parts of the region and also much in line with the already existing scarcity of opportunities in a sector largely dominated by governments and family-owned businesses. However, small to medium-sized businesses in the oilfield services or associated services segments in some Middle Eastern geographies may become more open to PE financing as distressed situations arise.

North America remains attractive
Nearly all respondents (99%) believe PE interest in North America will grow, as pressure from the low price of oil incentivizes an already lively and relatively risk-free market. This is a notable uptick from the 77% in 2013 who expected interest to jump. Many medium-sized companies will be looking to service debt, merge or sell assets, providing ample opportunity for firms looking to bolster their existing portfolios.

The US shale gas and oil boom has drawn major PE involvement over the past few years to basins, such as the Eagle Ford and the Bakken, and continues to grow at a time when the US is primed to become a net exporter. PE firms have also played a big role in financing liquefaction plants and export terminals projects, such as the Sabine Pass LNG terminal and Freeport LNG. “We are trying to expand in the US,” says the managing director at a US PE firm. “There are many fields and doing business here is simple. Demand is also slowly growing and there are numerous exit options. Liquidity is also quite high which reduces our risk.”
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Looking to invest in the region:
- **Africa**: 15%
- **Middle East**: 9%
- **Europe**: 48%
- **Asia-Pacific**: 41%

Currently active in the region:
- **Africa**: 1%
- **Middle East**: 3%
- **Europe**: 24%
- **Asia-Pacific**: 13%
The sheer size of the North American market makes respondents confident in future activity. Indeed, 63% of respondents rank the US as the top country where they expect the most PE activity to happen in the next 12 to 24 months.

**Europe on the rise**
With regard to Europe, 69% of respondents believe that PE interest will rise, especially as corporates resort to divestments to rebalance their finances leading to attractively priced opportunities for PE. “The European market will see a rise in PE interest, due to the presence of larger distressed assets that will offer bigger investment options,” says the partner at a Canadian PE firm. In addition, 48% are looking to invest in Europe in the next 12 to 24 months.

**Equity deals dominate**
Drilling down deeper into investment strategies for the different regions, respondents expect growth equity to be the most popular PE deal type, notably 98% in Asia-Pacific and 88% in North America.

“Companies that seek growth will often look for growth equity in order to finance a transformational event in their lifecycle,” says the partner at a US firm. “Due to the minor investments, there are smaller risks involved. We do not have to keep up with the costs of servicing bank loans or debt finance, allowing us to use the capital for business activities.”

While growth equity investments typically don’t provide investors with direct control of the company, careful due diligence and alignment of incentives between investors and management can often ameliorate the risks of a non-controlling interest. Providing growth equity for mature companies in the US and Canada poses fewer risks for investors, as those companies generally have a proven track record of performance. “Our investments encompass the oil and gas sector in Western Canada and are typically held for between three and five years. The ideal type of investments in this region would be providing growth equity since most companies are mature and investing in growth equity has lower risks associated,” says the managing director at a Canada-based PE firm.

Similarly, companies in Asia-Pacific have a solid business proposition but currently lack liquidity due to shrinking profit margins. One executive director at a Singapore-based PE firm says: “Asia-Pacific companies are not doing badly and they are in need of capital for paybacks and restructuring. We help these companies to succeed in their business and achieve growth. Right now, there is a huge amount of capital in the region and companies in the oil sector are taking measures to improve operations.”

**Distressed debt remains popular**
The second-most anticipated deal type is distressed debt acquisition, notably in the Middle East (100%) and Europe (94%). Companies that piled up debt during the boom years to fund expansion are now at risk with falling ratings and defaults are expected to surge as debt maturities arise. In particular, specialist distressed debt funds will be able to capitalize on situations of distress in Europe as well as in emerging markets where local lenders are becoming overleveraged.

In Europe, debts are mounting and profit margins are squeezed. For instance, a process of consolidation and restructuring is expected for North Sea companies as the UK government struggles to implement economic viability for the maturing fields in the UK Continental Shelf. See EY’s report *UKCS: Preparing for decommissioning* for more information.

PE may find some competition for distressed assets from strategics in the sector, where there has been interest from a number of majors seeking to understand the issues and approach to acquiring assets from distressed and near bankrupt companies, potentially by first acquiring below par debt of a target business in the secondary market.

In addition to pure equity or debt investments, hybrid investments and creative financing techniques can provide an alignment with the PE firms’ investment profiles and the oil and gas companies’ capital needs.

“Asia-Pacific companies are not doing badly and they are in need of capital for paybacks and restructuring. We help these companies to succeed.”

Executive director, Singapore PE firm
Which PE deal types do you most expect to see in the primary region(s) in which you invest?

<table>
<thead>
<tr>
<th>Deal Type</th>
<th>Asia-Pacific</th>
<th>Africa</th>
<th>Europe</th>
<th>Latin America</th>
<th>Middle East</th>
<th>North America</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth equity</td>
<td>98%</td>
<td>85%</td>
<td>28%</td>
<td>85%</td>
<td>22%</td>
<td>88%</td>
</tr>
<tr>
<td>Distressed debt</td>
<td>7%</td>
<td>8%</td>
<td>94%</td>
<td>4%</td>
<td>100%</td>
<td>20%</td>
</tr>
<tr>
<td>Private investment</td>
<td>62%</td>
<td>85%</td>
<td>2%</td>
<td>59%</td>
<td>11%</td>
<td>3%</td>
</tr>
<tr>
<td>Management buyout</td>
<td>12%</td>
<td>15%</td>
<td>51%</td>
<td>44%</td>
<td>11%</td>
<td>52%</td>
</tr>
<tr>
<td>Secondary buyout</td>
<td>2%</td>
<td>8%</td>
<td>26%</td>
<td>56%</td>
<td>38%</td>
<td></td>
</tr>
<tr>
<td>Pre-IPO investments</td>
<td>17%</td>
<td>8%</td>
<td>7%</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>
PE firms are set to become more involved in the midstream and upstream segments in the next two years, according to our survey. An equal share (44%) of respondents see the two sectors as their best opportunity for return on investment.

**Upstream**
The upstream sector lures investors with lowered valuations and the possibility of high returns. PE firms can reduce technical and exploration risk by investing in mature basins, where operational and cost efficiencies can increase profit margins and forward hedging can effectively lock in some stability.

With upstream debt-to-equity ratios currently highly leveraged, buying into upstream company debt is also an option for PE to enter the sector. And, indeed, 39% say they are attracted to the upstream segment, due to favorable valuations. Depending on the acquisition structure and the investment types that the PE firm will ultimately hold, significant tax considerations may exist with respect to the investments.

“The upstream segment provides the greatest investment opportunities,” says the managing partner at a US PE firm. “We always look at the analysis of well economics, including long-run sub-play production analysis, decline......
curves and then resource consistency and regulatory factors."

Given the variety of hydrocarbons resources, geographic spectrum and the number of players involved in upstream, this segment offers the greatest supply of targets – a draw for 25% of respondents.

**Midstream**

Midstream transactions have been a dominant force in oil and gas dealmaking over the past few years, especially the consolidation of pipelines in the US and Canada. The consistency and predictability of returns has been the greatest driver for respondents to get involved in the transport and storage segment.

In the current environment, some midstream assets are still doing well with fee-based, long-term contracts. Valuations in this segment have been steady and midstream assets, especially those held by upstream entities, may be put on the markets by those looking to raise money to help through the cash crunch.

PE firms could also support master limited partnerships (MLPs), which are publicly traded partnerships engineered for portfolio growth and payouts, but have recently experienced a financing gap.

Despite some activity in the MLP space, equity markets have been somewhat closed for many MLPs. While a number of potential MLPs sit idle waiting for the market to rebound, and a couple of MLPs have "rolled up" or consolidated within the past couple of years, opportunities exist for PE firms. With more potential consolidation, as certain MLPs are faced with rising debt levels and pressures on maintaining distributions, strategic growth capital may be an avenue for PE firms to deepen their exposure in the MLP space.

"As the midstream risk profile illustrates, transportation falls at the lower end of the spectrum with very low risk involved. As a heavily fee-based business with long contracts and only some macro-level commodity price risk exposure, transportation has been a favorite investment area for PE," says the managing director at a US PE firm.

Despite the historic attractiveness of the fee-based contractual structure, recent developments, challenges for upstream contractual counterparties, and the economic posture of some MLPs have led to renegotiations of long-term contracts. To the extent that a PE firm considers investing in the MLP space (and in the broader midstream segment), diligence of the applicable contracts, and the counterparties, is critical.

Which of the following oil and gas segments provide the greatest investment opportunity over the next 12-24 months?

- **44%** Upstream
- **44%** Midstream
- **10%** Oilfield services
- **2%** Downstream
Underdeveloped infrastructure, especially in Latin America, leaves room for new entrants in greenfield projects. For example, as Mexico reforms its energy sector, the country is launching a public investment vehicle known as FIBRA-E, similar to US-style MLPs for the build-up of Mexican midstream assets. While the FIBRA-E will be focused on Mexican assets, the structure is expected to offer a number of the features commonly found in MLPs and YieldCos.

**Downstream**

Only 2% of respondents name the downstream segment as their top choice for investment. High costs associated with modernizing and maintaining existing refineries may deter PE firms from investing in this segment. Product price volatility also makes returns uncertain but the risk is more manageable.

Key challenges for PE firms investing in refining assets would be the very specialized operational and management talent needed to successfully manage such investments. Refining may be the new midstream when it comes to asset risk in oil and gas – margins can be hedged – and small regional refineries, especially close to crude sources and that supply local markets, particularly in North America, can lock in profits by hedging the cost of crude and the sale of refined products. In combination with midstream assets, investors may yet consider refinery assets as strategic plays.

**Oilfield services**

Oilfield services can benefit from PE firms’ networks, management expertise and capital for technology acquisition that can bring cost efficiencies. Only 10% of the respondents find oilfield services the most attractive opportunity under current conditions.

“Although energy sector plays will always be subject to some commodity price risk, the oilfield services sector offers investment opportunities in traditional, established businesses often favored by PE,” says the managing director at a US PE firm. “The disaggregated nature of the industry offers an enormous number of opportunities for investment across the value chain and firms with a deep understanding of the industry’s economics have moved aggressively into this sector.”
“The upstream segment provides the greatest investment opportunities. We always look at the analysis of well economics, including long-run sub-play production analysis, decline curves and then resource consistency and regulatory factors.”

Managing partner, US PE firm
Funding matters

Strategic sales and increased fundraising are on the agenda for PE firms, but the valuation gap is still an issue.

58% expect PE sales to strategic investors to dominate their exit strategies.

Nearly nine out of ten (88%) believe the valuation gap between buyers and sellers has increased over the past year.

Close to two-thirds (64%) think that fundraising for oil and gas will increase in the next 12 months.
Our survey reveals that strategic sales are the expected exit route for firms and that fundraising for oil and gas will continue to increase – however, the valuation gap could still prove to be a stumbling block.

The majority of respondents expect sales to strategic investors (58%) to dominate their exit strategies, as the outlook for capital markets is uncertain following macroeconomic turbulence at the beginning of the year and stock devaluation via depressed commodity prices.

As sellers, PE firms believe they will get the highest return of investment from a sale to a strategic buyer. Large integrated oil majors have the firepower and the longer-term planning horizon to do deals of size in a still volatile environment.

"[The exit strategy] totally depends on the industry, nature of the business and valuation of the asset, but so far we have received the most value from sales to strategic buyers," says the managing director at a French PE firm. "Negotiations with these buyers are straightforward and there are fewer complexities if the deal terms are clear and the objectives are well defined."

However, many feel it is not a good time to monetize assets through a sale. While a majority (59%) say they have not delayed an exit on a portfolio company, a significant number of respondents say they have made such a delay (41%). Of the latter, 59% say the primary reason was an unexpectedly low valuation. As market fundamentals remain largely unchanged and steeped in uncertainty, sellers are not yet ready to meet buyer expectations of cheaper prices.

A feasible alternative to an outright sale is the MLP, of which 20% of respondents expect to be the dominant strategy for their portfolio companies. MLPs were on the rise before the downturn in the US, and offer the tax benefits of partnerships and the fundraising ability of a public company. The MLP offers a new source of liquidity and presents a strategic growth platform which draws on a capital stream separate from the sponsor’s remaining portfolio. While the market for MLPs has not been favorable over the past year, opportunities may yet exist for PE firms to play a significant role in existing and to-be-formed MLPs.

"The MLP seeks to support distributable cash flow with a stable source of deals for the publicly traded MLPs," explains the partner at a Canadian PE firm. With the general market expectation that MLPs will be acquisitive and will increase distributable cash flow, an uncertain commodity price environment, the relatively closed equity markets and the continuing bid-ask spread challenges, mean that an MLP exit has a different profile than it did in the recent past. To the extent that an exit is desired prior to the MLP equity market rebounding, a sale to strategic acquirers still represents the preferred exit opportunity for PE firms.

Even in a positive MLP equity environment, a sale to a strategic acquirer may still be preferred, depending on the holding period desired by the PE firm. To the extent that a complete exit is desired in a short period of time, a sale to a strategic acquirer...
(including an existing MLP) would provide a quicker path to a complete exit as compared to forming a new MLP. However, to the extent that the PE firm desires to grow the performance of the underlying asset inside the MLP structure and hold the investment (or part of it) for some amount of time, an MLP may be the preferred alternative (again, assuming that the MLP market rebounds and becomes welcoming to new entrants).

**Mind the gap**

Despite persistent low oil prices, sellers are still reluctant to price this into their valuations. This point is underlined by 93% of respondents, who see a significant gap in expectations between buyers and sellers. And 88% say the price dislocation has increased over the past year.

“The valuation from the sell side is higher, which is not acceptable to the buyer as they are linking the valuations to the low price of oil,” explains the managing partner at a Canadian PE firm.

Several buyers got burnt after investing in 2015, only to see Brent crude drop to a new low in early 2016. The first wave has passed and smart buyers are now waiting on the sidelines for fire sales, following new rounds of re-evaluations for reserve-based lending, which is pushing sellers into lowering valuations.

“Buyers are following the market valuations, but the sellers are focused fully on the intrinsic value of their company,” says the partner at a US firm. “There is also shareholder pressure and a lot of other factors widening this gap in valuations.”

**Finding funds**

Energy-focused funds had a big year for financing in 2015, accounting for 79% (62 funds) of all natural resources funds closed and 90% (US$62.4b) of total aggregate capital raised, according to research firm Preqin. And respondents feel that the record levels of fundraising will increase further. Sixty-four percent believe that PE will look to tap more capital for oil and gas in 2016, while 28% expect fundraising activity to continue at the current pace.

The “low-for-longer” oil price environment necessitates increased capital raising for companies to weather the downturn. The stream of oil and gas firms filing for bankruptcy so far this year demonstrates the trouble that the industry faces. A report by ratings agency Fitch in May found energy companies had already defaulted on US$26b in debt in 2016, compared with US$17.5b in all of 2015.

With the clear need for capital, it is understandable then that 71% of respondents plan to raise funds for acquisitions in the sector over the next 12 to 24 months.

Those planning to fundraise for investment cite the rising capital needs of oil and gas companies, and are doing so to be ready to take advantage. “We are planning to raise a new fund targeting acquisitions, as there are opportunities that will spring up in the sector and we want to be prepared,” remarks one managing director at a PE firm.

Those not looking to raise capital mostly have funds ready to invest in the sector. However, some provide a more cautious opinion: “Looking at the current market, we believe that it’s not the right time for raising a new fund targeting acquisitions in oil and gas,” says a partner at a US firm. “They are already going through a tough time, and we believe that if we raise funds, we would be inviting more risk for our organization.”

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1 Preqin, “Q1 Fundraising Update,” April 2016.
Do you think fundraising for oil and gas over the next 12 months will:

- Increase: 71%
- Stay the same: 64%
- Decrease: 28%

Do you plan on raising a new fund targeting acquisitions in the oil and gas sector in the next 12-24 months?

- Yes: 71%
- No: 29%

“Buyers are following the market valuations, but the sellers are focused fully on the intrinsic value [of their company].”

Partner, US PE firm

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Top 10 global PE deals in the oil and gas sector, Jan-May 2016

<table>
<thead>
<tr>
<th>US$</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>4,362m</td>
<td>Range Resources Corporation (USA) bought Memorial Resource Development Corp. (USA)</td>
</tr>
<tr>
<td>3,300m</td>
<td>Energy Capital Partners, LLC; Dynergy Inc. (USA) bought Engie SA (US fossil business) (USA)</td>
</tr>
<tr>
<td>1,470m</td>
<td>First Reserve Corporation; EnCap Investments L.P.; Kayne Anderson Capital Advisors, L.P.; The Energy &amp; Minerals Group; EnCap Flatrock Midstream (USA) bought Plains All American Pipeline, L.P. (12.3% Stake) (USA)</td>
</tr>
<tr>
<td>834m</td>
<td>Magnetar Capital Partners, LLC; Stonepeak Infrastructure Partners (USA) bought MPLX LP (USA)</td>
</tr>
<tr>
<td>755m</td>
<td>ENN Ecological Holdings Co., Ltd. (China) bought Santos Ltd (11.72% Stake) (Australia)</td>
</tr>
<tr>
<td>613m</td>
<td>Macquarie Infrastructure and Real Assets; Swiss Life Asset Management AG (Australia) bought Societa Gasdotti Italia S.p.A. (Italy)</td>
</tr>
<tr>
<td>500m</td>
<td>Warburg Pincus LLC (USA) bought Rimrock Midstream, LLC (USA)</td>
</tr>
<tr>
<td>375m</td>
<td>Trilantic Capital Partners LLP (USA) bought Indigo Minerals LLC (USA)</td>
</tr>
<tr>
<td>312m</td>
<td>ENEVA SA (Brazil) bought Parnaiba Gas Natural SA (72.75% Stake) (Brazil)</td>
</tr>
<tr>
<td>200m</td>
<td>International Finance Corporation; China-Mexico Fund (USA) bought Citl Energy S.A.P.I. de C.V. (Mexico)</td>
</tr>
</tbody>
</table>

Source: Mergermarket
Capitalizing on opportunities
Private equity investment in oil and gas

Finding the needle in the haystack

It seems PE firms have been hesitant to act until the oil price settles but, to gain a first mover advantage when that happens, preparation is required to find the right fit for existing portfolios.

43% expect PE investors to begin deploying their dry powder in H1 2017

71% are exploring new capital structures and/or strategies

77% think they will use commodity price hedging to protect returns over the next 12 to 24 months
While opportunities are presenting themselves and commodity prices have stabilized somewhat, our survey reveals PE firms are biding their time.

Early predictions of the oil price decline being short and sharp have been confounded, leaving a number of unsuspecting oil and gas companies in its wake. With these factors in mind, investors are hesitant to invest until they feel the bottom of the cycle has been reached. Expectations at the start of 2015 were that PE would be increasingly involved in the sector as the year progressed — expectations that have not come to fruition.

However, close to half of respondents (43%) expect PE activity to pick up in the first half of 2017. First-mover advantage will be key when debt maturities arise, or the price of oil rebounds. As a result, 30% believe that PE investors will start investing their huge supply of dry powder before the end of 2016.

Respondents are quick to note the current market conditions as being a key factor in delaying PE dry powder deployment. “I think PE firms will currently hold on to their liquidity, and more emphasis will be placed upon the development of existing portfolio companies,” says the managing partner at a US PE firm. “They will begin investing again in the first half of 2017 since the current market conditions aren’t very stable and making investments would not be very wise at the moment.”

A quarter of respondents expect PE investors to become active toward the end of the year. Some respondents believe this is the point when oil and gas companies will be under most pressure. “PE investors across the globe will be active in the dealmaking space,” says the managing partner at a Canadian PE firm. “By the end of 2016 the volume of activity will hit its peak. The situations in East Asia and Europe are deteriorating, giving more opportunities to potential buyers to acquire more competitively.”
New structures
The majority of respondents are exploring new capital structures (71%), while 29% believe the sector has little room for new asset classes and will remain reliant on pre-existing strategies.

Exploring other ways to structure capital has become almost mandatory for many PE-backed companies, simply due to the debt burden many of those firms carry. “With the lack of capital in the market and the need to restructure to manage and reduce debt, companies are looking for new investment opportunities,” says the managing director at a US PE firm. “They are adopting new models and strategies and are trying to raise capital using joint ventures and selling out their debt to other companies.”

Structures, such as joint ventures, are being used so oil and gas companies can conserve capital. Of those who think investors are exploring new capital structures and strategies, the majority believe joint ventures (JV)/drillcos (62%) and contingent pricing (59%) are the most popular options to explore.

JV structures can help PE firms cut costs in their indebted operating companies. A variety of alternatives exist in structuring JV arrangements, each with their own significant tax considerations. PE firms looking to structure a JV should consider tax attributes, historical tax exposure items, the method in which items of income, gain, loss, deduction, and credit will be shared among the parties, and the impact of the arrangement on the overall capital entitlement of the parties.

One such JV arrangement, referred to as a drillco structure, may be used for the investor to obtain an acceptable, almost preferred-like return, and with the company being able to access equity funding without sacrificing a material amount of long-term ownership of the asset base — something that could help bridge the valuation gap. Many hope, however, that using contingent pricing could bring much-needed stability.

“Contingent pricing is targeted at steadying oil prices so that rates can rest around US$75 per barrel and market equilibrium can be achieved,” explains the managing director at a Canadian PE firm.

In addition to contingent pricing and joint ventures, creative financing structures involving hybrid investments are expected to remain a viable option in the current economic environment.

Hedge holders
Hedging activity held much of the industry afloat in 2015, but as the hedges expire or are otherwise winding down in 2016, write-downs are starting to come into effect. However, while the oil price has been creeping up slowly, more than three-quarters of respondents say they will use hedges to protect returns over the next 12 to 24 months.

Almost two-thirds of the respondents also feel the terms and supply of hedging will be more favorable in the coming one to two years. One partner at a Dutch PE firm who feels the terms will be increasingly favorable believes the increased uncertainty has simply created a fluctuating marketplace where hedges are necessary. “In the next 12 to 24 months, commodity hedging will be more favorable as the market has not yet settled much,” he says.

However, all acknowledge hedging by itself can mitigate but can’t change the medium-term impact of market fundamentals. “There is no doubt hedging will protect against inflation, but things will not get back to normal within the span of 12 to 24 months,” says a partner at a US PE firm.
Do you expect the availability and terms of commodity price hedging to become more or less favorable over the next 12-24 months?

64% Yes
36% No
Concluding comments

In an uncertain and volatile world, PE firms looking to invest in the oil and gas sector need flexibility, patience and clear strategic plans.

Call to actions

PE firms should start building relationships with the market to scout opportunities for acquisitions or strategic alliances.

Embed flexibility in portfolio companies. Ensure companies have a transparent capital structure and flexible financing options.

Build a complementary portfolio, considering new deal structures involving strategic alliances and supply chain integration.
Amid global uncertainty and a tumultuous macroeconomic environment, change in the oil and gas sector is increasingly a question of “how,” rather than “when.” The impending changes provide an opportunity for PE to play a valuable role in transforming the oil and gas sector.

As stress in the oil and gas sector continues, providing both short-term and long-term financial solutions has become one of the most important ways in which PE firms can lend support. There are several advantages to debt funding, such as maintaining existing operations, financing short-term needs and fixed interest rates.

Equity investments and the provision of debt funding for portfolio companies is a vital part of keeping the sector afloat. Our survey shows the majority of respondents in PE are planning to raise new funds to invest in the sector over the next year.

The majority of respondents also believe that growth capital will be a crucial aspect for corporates to maintain market momentum and leverage through geographic expansion.

However, acquisition activity has so far been constrained by the uncertainty surrounding the downturn, which has slowly introduced the concept of strategic growth in an era of resource abundance — an oversupply of oil and gas but less capital availability.

The Brent crude front month settling at a resistance level around US$44/barrel in May of 2016, may start to accelerate price discovery in the market and allow those deals stalled because of a valuation gap to restart.

The expectation is for 2017 to be the year when dealmaking picks up and both corporates and PE firms will be vying for quality assets.

Looking ahead, the majority of respondents anticipate PE will play a vital role in the fortunes of oil and gas to come.
Capitalizing on opportunities
Private equity investment in oil and gas

Oil and gas is a continually transforming sector, requiring players to grapple with rapid changes that were not foreseen or seemed remote when company strategies were last developed. Companies need to respond to the changing landscape flexibly, proactively and competitively by incorporating and preserving optionality in their portfolios.

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